SUBCOMMITTEE ON INVESTIGATIONS AND OVERSIGHT FIELD HEARING IN PITTSBURGH, PA ON ACCESS TO CAPITAL FOR SMALL BUSINESSES

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES
HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

HEARING HELD
May 17, 2010

Small Business Committee Document Number 111-068
Available via the GPO Website: http://www.access.gpo.gov/congress/house

U.S. GOVERNMENT PRINTING OFFICE

56–298 PDF WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
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SUBCOMMITTEE ON INVESTIGATIONS AND OVERSIGHT FIELD HEARING IN PITTSBURGH, PA ON ACCESS TO CAPITAL FOR SMALL BUSINESSES

MONDAY, MAY 17, 2010

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Subcommittee met, pursuant to call, at 2:00 p.m., at Ross Municipal Building, Council Chambers, 1000 Ross Municipal Drive, Pittsburgh, PA, Hon. Jason Altmire [Chairman of the Subcommittee] presiding.

Members Present: Representative Altmire.

Chairman ALTMIRE. Good afternoon. This hearing will come to order. In recent weeks, economists have pointed to a number of signs suggesting the economy is improving. The number of new jobs created in April was the highest in the past 4 years. April also marked the fourth consecutive month for positive job creation. Consumer spending is on the rise and the manufacturing sector is expanding. The first quarter of 2010 saw our Gross Domestic Product grow by 3.2 percent. Here in Pennsylvania, 22,000 new jobs were created between February and March of this year.

These are all positive indicators, but we still have a long way to go. Despite what any economist says, the recession won't truly be over until Americans seeking work can find jobs. And that is going to take a resurgence in the small business sector. Commentators often refer to small businesses as the backbone of our economy, but the fact is after every recession small business firms had led the way back to prosperity. However, if small businesses are the economy's backbone, then capital is its lifeblood, and without access to capital, startups cannot launch and create new employment opportunities. Absent affordable credit, existing businesses cannot grow and bring on more workers.

As Congress and the Administration work to improve the flow of capital to small businesses, Pittsburgh can offer some valuable lessons. Here in Western Pennsylvania, we have reinvented our local economy in recent years, developing new industries and becoming a magnet for innovative entrepreneurs. All of that happened because small firms had financing options to help them get off the ground, expand an create jobs. It is my hope that today we will hear which policies have worked, and how to go forward in helping more firms find affordable loans.

Congress has already taken some steps to get credit flowing to small businesses. Since being enacted last year, the American Recovery and Reinvestment Act has helped support $26 billion in small business loans. And here in Pittsburgh, we have seen a spike in the amount of money lent to small businesses through the SBA programs. For local firms, SBA loan volume is on track to almost double this fiscal year over fiscal year 2009, but we still need to do more. Toward that end, the Small Business Committee developed the Small Business Financing and Investment Act, which passed the House in October with widespread, bipartisan support. Once enacted, that bill will deliver $44 billion in lending and investment.

By modernizing the SBA's programs, that legislation will cut red tape, funnel more loans to entrepreneurs and build on the successes of the Recovery Act. And later this month, the House will vote on another proposal, which will be aimed at pushing smaller, community banks to start lending to small businesses again. Solving the small business credit crunch is nothing short of essential to our economy recovery, so we have to get this right. That means listening to and learning from the entrepreneurs who are driving our recovery forward.

Today, we are fortunate to have with us some of Pittsburgh's most innovative entrepreneurs, and our local lending community is represented as well. It is my hope that this discussion will provide insight as to what is happening here in western Pennsylvania from the perspective of both lenders and borrowers. We need to hear these important perspectives in order to craft effective policies that get credit flowing, businesses growing, and results in the jobs Americans need. I want to thank the witnesses for taking time away from their businesses to join us today to offer their perspectives and valuable expertise on this very important subject.

[The statement of Mr. Altmire is included in the appendix.]

Chairman ALTMIRE. With that, let me introduce our first witness. That is what my statement says, but let me just say before that what this is about. On the Small Business Committee, we are in the process of going through this exercise across the country having hearings in all parts of the continent to talk about what we can do better with regard to access to capital bringing together lenders and borrowers, small businesses to talk about the problems that we have had with access to capital and what we can do on the Small Business Committee and in the Congress to get it right because we have had some good news with the economy. The GDP growth has been strong for the last 3 quarters. The job growth has been strong in recent months. The stock market certainly is doing much better than it was a year ago.

The problem is the last indicator that hasn't improved as much as we would like is access to capital, and that is what this is about. So I am going to first introduce—we are going out of order here, so I am going to start with Eric Zarnikow. Am I pronouncing that correctly? Zarnikow. Mr. Eric Zarnikow is the Associate Administrator for the Office of Capital Access in the U.S. Small Business Administration. Mr. Zarnikow is responsible for the management and oversight of SBA's lending and financing programs. Welcome, Mr. Zarnikow.

STATEMENT OF ERIC ZARNIKOW

Mr. ZARNIKOW. Thank you, Chairman Altmire. I am honored to be here today. One of the missions of the Small Business Administration is to provide small business owners with access to much needed capital. We do that primarily by providing a partial government guarantee on loans made by banks and other lending partners. This guarantee helps provide access to capital for creditworthy small businesses that would otherwise be unable to get loans. To address disruptions in the credit markets, the Recovery Act temporarily raised the maximum available guarantee on some SBA loans to 90 percent, and allowed us to reduce or eliminate most of our fees.

The raised guarantee provided an extra incentive for risk-averse banks to lend to small businesses, and the fee reductions made the loans more appealing to borrowers. As a result, SBA lending has increased by about 90 percent since the passage of the Recovery Act. We have turned about $600 million in taxpayer funds into support for $26.5 in loans to small business owners. This includes over $637 million in Pennsylvania, and over $40 million here in the 4th district. We know that times are still tough for small business owners. While SBA's recovery loans are helping, it is clear that many small business owners are still having a hard time getting access to credit. Moreover, declines in home values have hurt small business owners because many entrepreneurs use home equity to help finance their business. We know that there is still much more work to do.

At the SBA, we have examined how to use our programs to address demand for credit, availability of capital, and risk tolerance, and with the President we have proposed a jobs plan which targets gaps that still exist. There are 5 key components to this plan. First, to address the issue of banks that still have trouble taking risk, we have asked for a long-term extension of the increased 90 percent guarantee and the reduced fees. Second, for banks that don't have the capital to lend, we have asked that Congress direct $30 billion to a small business lending fund to provide capital to community banks to allow them to lend more. This money would come with incentives to increase lending to small businesses.

Third, many small businesses need bigger SBA loans to help them create jobs. This might be franchisees, manufacturers, exporters, and others, and we would like to increase the top loan limit in our program from $2 million up to $5 million. Fourth, for businesses that can't find access to working capital, we would like to temporarily raise the SBA Express Loan limit from $350,000 up to $1 million. These loans will help businesses restock shelves and fill orders that they have coming in.

Fifth, we know that many small businesses have conventional, owner-occupied commercial real estate mortgages that will need to be refinanced soon. As real estate values have declined, many banks will find that these businesses no longer qualify for conventional loans, regardless of the strength of the business. As a result, even small businesses that are performing well and making their payments on time can have a hard time refinancing these loans and may face foreclosure. So we want to open up SBA's 504 loan program to commercial real estate refinancing for owner-occupied commercial real estate. It is critically important that we prevent creditworthy firms here in Pennsylvania and across the country from facing unnecessary foreclosure and lost jobs. 504 refinancing will allow them to lock in stable, long-term financing, while freeing up banks to make even more small business loans.

This plan is guided by basic principles: build on what works, maximize limited taxpayer dollars, and make targeted changes as quickly as possible. It addresses specific gaps in demand, availability of credit, and risk tolerance. SBA is confident that this will allow us to continue to help small businesses in this tough economic climate.

SBA is committed to building on the success of the Recovery Act by expanding points of access and bringing more small businesses into a long-term banking relationship with an SBA lender. In addition, we will continue to work hard on behalf of small businesses everywhere. Our field staff and resource partners are standing by to help small business owners and entrepreneurs as they start and grow their business. Small business owners here in Pennsylvania have access to 2 district offices in Philadelphia and Pittsburgh, 17 Small Business Development Centers throughout the state, 4 Women's Business Centers and also a Veteran's Business Center, and several chapters of SCORE, our retired executives mentoring service.

I want to thank you for your support and leadership for small businesses, and for working with SBA to get them the support they need. And I am happy to discuss any of these proposals or answer any questions. Thank you.

[The statement of Mr. Zarnikow is included in the appendix.]

Chairman ALTMIRE. Thank you for being here, Mr. Zarnikow. Mr. Chuck Leyh is President and co-founder of Enterprise Bank in Allison Park, Pennsylvania. Mr. Leyh is also a CPA with over 30 years of experience. Enterprise Bank assists small businesses and specializes in helping startups and distressed companies. Currently, Enterprise Bank is the largest dollar volume SBA lender in all of Western Pennsylvania. Welcome, Mr. Leyh.

STATEMENT OF CHUCK LEYH

Mr. LEYH. Thank you. On behalf of Enterprise Bank and the Pennsylvania Association of Community Bankers, I want to express my appreciation to Congressman Altmire for giving us an opportunity to speak to you. We prepared our written testimony, and I would like to take a minute to just on an impromptu basis discuss the 4 component parts that are in that written testimony.

Chairman ALTMIRE. And your entire statement will appear in the record.

Mr. LEYH. We are in agreement with the basic 5 provisions that are in the new law, the proposed new law that the SBA is pushing. The 90 percent guarantee has made a significant improvement, and we believe one of the strongest contributing improvements to lenders being involved with the SBA program. In the business of banking, risk mitigation is our lifeblood, and obviously when you take the risk off of the bank's shoulders and put it onto the program's shoulders, you motivate the banking community to be more active, so that is an incredibly important tool. What we would like to emphasize though are there are some other provisions that are more day-to-day operational or regulation structure changes that, in fact, inhibit some of these programs from being fully utilized, and they are outlined in our written testimony and broken into 4 component parts.

The first is centralization. SBA went through years ago a centralization process for purposes of processing loans and guarantees, and we think it is a tremendous tool in making it a much more efficient operation. But any opportunity to centralize communications becomes a challenge, and, in fact, we see situations where the lack of a local presence of authority creates a problem when it comes to mitigating problems or correcting problems in the processing units. There are 3 examples that we gave here but we can give you multitudes of additional ones.

It should be highlighted that it is both an efficiency concern with regard to processing when we find mistakes and we try to get them corrected. It takes too long without having a strong local presence that has the authority to do something, but it also has to do with saving dollars for the program. One of the examples that we included in here was a situation we just recently have gone through where in a collection process under the 504 program, we had a situation where we had approximately a lender that had about $5 million in collateral, and we were in the first position with approximately $2 million, and the SBA was behind us in a second position for less than that amount, but significantly greater than a million dollars.

When we went through this whole process, SBA did not get involved in court proceedings or cooperating with us, and as a result the bankruptcy judge did some things that, in effect, cost the government over a million dollars, which certainly there are tremendous values to centralization but without that lack of a local presence and mistakes like this being made there is a lot of expense that is being generated.

The second major area that we wanted to discuss and highlight was the new lender rating system. This system basically evaluates a bank on a 1 to 5 scale and is discussed as an important parameter as to whether a bank is allowed to be in the preferred lender program, which is important to a large volume lender. In this situation, when you look at the component ratings, the losses, the credit scoring system, it is very hard for a bank to equate that system to the whole mission of the SBA and the eligibility concept involved in the SBA lending.

Prior to this concept being put in place and having an enforcement provision associated with it, when you evaluated the loan, you look at the SBA eligibility requirements and you looked at it from a risk mitigation yourself where 25 percent of the loan you were at risk for, and the government, in effect, was at risk for 75 percent (based upon the old percentages). And that risk is something you weighed in making your underwriting decision. Now you are looking at it from a different perspective. Now you are looking at it from this rating system perspective, and, in fact, in our particular bank's situation, our rating has been lowered recently. So when it came time for Congress to implement the ARC program that was part of the assistance in this recession where the law encouraged us to make a loan for people to make their loan payments on troubled debt, our bank concluded not to participate in the program because we couldn't afford to have losses show up in that lender rating portal analysis.

When we have had discussions as to how do we reconcile this with the mission of the SBA the examiners that have come in to us have kind of looked at us and said you know what it takes to improve your losses, and, in fact, we do. It means higher risk lending we start to back away from. But does that really tie in to what the mission of the SBA is? What it equates to is it says don't make restaurant loans in lower income areas. Don't make loans that are higher risk, and, in particular, in our experiences low income areas have a higher risk associated with them. Prior to this rating, we paid no attention to where somebody was located, what level of income they had, the conventional underwriting concepts. We just looked at it and said do they have a good business plan? Does it look like they have thought through the program well? Now we look at it and say what is their scoring, what is their credit scoring, are they in a low income area, are they in a high risk business or area? And we ignore or minimize the typical eligibility standard in favor of more of a risk mitigation and underwriting concept. We think that Congress needs to look at the mission of the SBA and look at this lender rating system and give us specific guidance as to how to mirror the two and in what direction a lender is supposed to operate in.

The third area is in new regulations where we think that Congress has to look at the regulations that are being put out by the SBA and again see and look through what the cause and effect is. For instance, now one of the changes that the SBA has put in place, it says when a loan is evaluated by an appraiser they want after the building has been built, they want the appraiser to come back and certify that it is what they did the original appraisal for, which is a good practice. But the regulation goes on to say the appraiser needs to verify that the building was built according to its original specs. Well, that is not the expertise of an appraiser. That is the expertise of an architect or an engineer. Now we have appraisers who won't sign off on this documentation because they are concerned that this request is beyond their profession's capacity. Those are the kind of things that we need to look at closely before we put regulations in place.

And the last item we wanted to highlight was the guaranteed payment problems that are in the system. This has caused a lot of lenders to diminish their activity level or back out of the program, and those examples are highlighted in here but the basic solution there also is to have a local person that has authority to work through the problems as they are encountered. I appreciate the opportunity to speak, and I think I have more than used my 5 minutes.

[The statement of Mr. Leyh is included in the appendix.]

Chairman ALTMIRE. Thank you, Mr. Leyh. Now Ms. Marilyn Landis is President and CEO of Basic Business Concepts in Pittsburgh, Pennsylvania. Ms. Landis has over 30 years of experience in financial services. Basic Business Concepts provides an array of services to small businesses and business brokerage services. Welcome, Ms. Landis.

STATEMENT OF MARILYN LANDIS

Ms. LANDIS. Thank you. Thank you. Just to mention and add a piece on to who I am, I have offices scattered throughout the United States, but I have a heavy concentration in Pennsylvania and in Ohio, so very versed on the economy as we are here. I am also the 2009 SBA National Financial Services Champion. And I would like to thank you, Chairman Altmire, for holding this very timely hearing and for inviting me to be part of it. Thank you. Prior to starting Basic Business Concepts, I spent 30 years working for and with commercial lenders, banks and small businesses. I worked for 3 of the largest U.S. small business lenders in the country, marketing, originating and underwriting SBA loans, and have continued working with my clients on securing SBA loans, as well as a myriad of other sources of capital.

After 38 years of working with small business, the one thing I can tell you without hesitation is it is tough out there. Small business owners face many obstacles in trying to garner capital, obstacles that illustrate the very significant need for, and importance of, the SBA's lending programs. Many small and startup businesses lack the assets necessary for a traditional bank loan. In 2010, these are the businesses who have burned through their savings, their reserves, and even their retirement accounts to meet their obligations. They have scaled down to the new reality, found new customers, shattered unprofitable lines, added new divisions with better sales, prospects, and margins. In short, we did all the right, responsible things. We are here receiving orders and unable to secure working capital.

Smaller loans are generally less profitable for banks and typically have a higher default rate. The increased usage of personal credit ratings for business owners further exacerbates the problem. One of the biggest barriers to small business financing is debt secured by equity and fixed assets. Many small business owners do not have the kind of equity required by banks to acquire a sizable loan. This gap in debt equity financing primarily hinders both startup businesses and growing businesses. An entrepreneur wishing to open any business would face significant barriers to financing. The small business owner seeking to expand his or her business or hire additional employees faces the same equity challenges.

The balance sheets for most small businesses especially in today's economy are not composed of significant fixed assets especially significant in light of the emerging commercial real estate crisis. Even the fixed assets the business does own are likely devalued. A new capital issue has come to the forefront for small businesses, and that is the increased reliance on credit cards. Many small business owners were forced to turn to credit cards as their primary source of working capital in the early years of this decade when a multitude of banks tightened their lending standards.

In December of 2009, 78 percent of the respondents to an NSBA survey reported that they had been impacted by the credit crunch causing 47 percent not to expand their business. Banking practices that restricted access to capital were a key catalyst in the creation of the SBA's flagship 7(a) loan program. As you can see, however, imperfections within the market still exist, and SBA loan programs are as important now as ever. Congress should be pleased the American Recovery and Reinvestment Act, while not a cure all for the credit crunch, the temporary elimination of the upfront borrower fees and the increased guarantee for SBA loans have been instrumental in a recent uptick in SBA lending.

Given this tremendous success, it is vital that Congress immediately extend these provisions through all of 2010 on a reliable, sustainable basis that the lenders can build strong origination and compliance programs around. The fact that SBA volume has mirrored the availability of the program confirms the lenders need the increased liquidity it affords. SBA programs have served a key role in making capital available to small business. The use of the SBA programs have enabled lenders to meet the needs of their borrowers with the SBA guarantee to mitigate the reach outside of their normal criteria.

The SBA has made changes to the standard operating procedures to meet both the need for increased credit quality and increased flexibility in order to meet current access to capital needs. There are necessary changes, however, that cannot be made solely through the SOP. These changes must be made legislatively. I would like to recommend the following changes. First, permit borrowers to pledge additional collateral for a refinance, for example, real estate, in order to secure a longer term lower payment in order to improve cash flow. Currently, the law does not permit calculating a SBA loan term based on the underlying collateral. Second, permit the SBA to work with lenders to support loans advanced against projected sales. This could be accomplished in more than one way. If the lender and the borrower agree, for example, to a projected sales plan that rebuilds the business the lender would receive a reduced SBA guarantee for the first year to ensure both lender and borrower are committed to the viability of the projections.

If the borrower makes all payments for the first year the bank would receive an increase in the guarantee amount to the full amount available under the SBA program. The second way to support loans for projected sales is to raise the cap on the SBA CapLine program. These programs, which finance purchase orders and contracts, are by their nature more costly for the lender to offer. An increased rate cap would permit the lenders to participate in this program at an interest rate level that is commiserate with their requirements for profitability and still meet the borrowers need for affordable financing. A legislative change is also required in order to open the SBA's very practical international line of credit program to domestic receivables. Currently this program can only be used for international sales.

I also urge Congress and this Committee to address 2 additional aspects of the credit card industry that urgently need reform, the absence of explicit protections for small business cards, and, two, the secretive and unfair interchange fees. The Administration and Congress must fully support small businesses as the true centers of growth in U.S. economy. Congress must recognize that the majority of small businesses in today's economy are not fixed asset intensive and should take the lead ensuring the traditional financing practices and new credit card policies do not restrict small business growth.

I urge Congress to examine the benefits of reforming the current limitations placed on banks and lending to small businesses and fully supporting and funding existing SBA loan programs. I thank you for your time, and welcome any questions you may have.

[The statement of Ms. Landis is included in the appendix.]

Chairman ALTMIRE. Thank you, Ms. Landis. Finally, Mr. Karl A. Kaluhiokalani is President of RRC Consulting Group in Pittsburgh, Pennsylvania. Mr. Kaluhiokalani has extensive experience in training, strategic planning and performance management. RRC Consulting Group provides engineering services for commercial, public and residential properties. Welcome, Mr. Kaluhiokalani.

STATEMENT OF KARL A. KALUHIOKALANI

Mr. KALUHIOKALANI. Thank you, Mr. Chairman, for inviting me to present testimony today. As a member of the small business community and participant in SBA programs what is discussed today has a major impact on my business, the same as other small businesses. In this period of economic stress, it become even more important to support small business through effective utilization and management of existing programs while correcting the chronic deficiencies identified and discussed by Congress many times in the past several years. Past budget, staff, and program cuts have hindered the ability of the SBA to properly manage programs, adjust to changes in technology, and meet additional demands of a growing small business population.

According to the U.S. Census Bureau, between 2002 and 2006 small businesses fewer than 100 employees have averaged an increase in employment of 24.8 percent while those businesses greater than 100 employees averaged only a 4.15 percent increase. As a point of information, the SBA defines a small business as having under 500 employees. According to the SBA in a report prepared in September of 2009 small businesses represent 99.7 percent of all employer firms, employed just over half of private sector employees, pay 44 percent of total U.S. private payroll, have generated 64 percent of net new jobs over the past 15 years, create more than half of the non-farm private gross domestic product, and hire 40 percent of high tech workers such as scientists, engineers, and computer programmers.

Given the recognized importance of small businesses to our economy it becomes increasingly frustration when emphasis has been placed on big business. So far, billions of taxpayer dollars have gone to bail out financial institution and the auto industry while little effective effort has been made to save the small businesses that are failing every day. Without jobs, people can't buy cars, save money or invest to make our economy stronger. Even though financial institutions received funds to ease the credit crunch, lending has only tightened forcing small businesses to close or go into bankruptcy. Credit lines have been cancelled, loans are not available, and interest rates have risen on current lines of credit making it almost impossible for small businesses to survive and service debt.

The recent changes in the SBA loan guarantee program are more beneficial to companies with over 100 employees and of little value to the mom and pop businesses typically with less than 10 employees. A borrower must comply with the lending policies of the institution providing the loan and without work or sales and a strong balance sheet a small business is unable to obtain a loan. Rather than securing loans, most small businesses are in need of additional work or sales to pay employees, service debt, and expand their business. Unfortunately, the federal government does not have the capacity to assist all small businesses in increasing sales revenue, however, through programs established by Congress has the ability to influence federal purchasing and procurement.

Most of these programs are administered or overseen by the SBA. However, as indicated previously, the SBA has lost its effectiveness and many of the established programs are in need of review and revision to make them work as intended. These situations have been discussed by Congress many times and examples of these deficiencies continue to be a problem and are outlined in my written statement. In conclusion, I urge the members of Congress on behalf of myself and small businesses overall to address these issues with effective legislation to promote small business growth, create additional jobs, and move our economy forward at a greater pace. Thank you for your consideration.

[The statement of Mr. Kaluhiokalani is included in the appendix.]

Chairman ALTMIRE. Thank you. And thanks to all the witnesses, and I wanted to again take a moment to explain what this is about before we open it up for questions. As I indicated, the Committee is having field hearings all around the country to talk about this issue and meeting with the SBA regional offices and so forth, and I just wanted to make a point that we have the staff director for the U.S. House Small Business Committee, Mr. Michael Day, here in the back. He is the top guy on the Committee. He is here with us today. We, of course, have a stenographer from the Committee, and everything that you say is being recorded for the purposes of taking this information back to Capitol Hill, trying to figure out a way to make things better, and what you are going to say today is going to help us sort through these very important issues.

And, Mr. Zarnikow, and members of the Committee, I would point out the 3 constituents that you have heard from today are certainly representative of my district and of the concerns I have heard from dozens of other business owners and lenders and people who have experienced some of the problems that we are talking about today. But I would say while there are 3 that are representative of my district, they are probably the 3 most articulate on these issues, and I think you have seen that today, and I really do appreciate each of you being here to join us, as well as you, Mr. Zarnikow. Thank you.

For the first question, I did want to talk about the SBA in particular, and in fiscal year 2009 regarding the 7(a) loan program only 10 lenders made over 20 percent of all 7(a) programs, and I was wondering that at a time when the nation is struggling to recover from over concentration of risk in a few large banks, what is the SBA doing to ensure that the SBA does not become dependent on only a few large banks to meet its capital access mission?

Mr. ZARNIKOW. At SBA one of the things that we are very focused on is increasing the points of access for small businesses to the SBA program, so one of our high priority strategic goals is to increase the number of points of access. What we are working hard to do is to get additional lending partners into our programs, whether that is banks, credit unions, small business lending companies, and other non-depository lenders. In fiscal year 2009, we saw that the number of points of access when our fiscal year ended in September, was about 2,771 lenders. This means that about 2,771 lenders made at least 1 SBA Loan. That was up about 15 percent from the prior year.

And currently we have over 4,500 different lenders who have at least 1 SBA loan in their portfolio. So we are very focused as an agency on increasing the points of access to capital and getting as many lending partners into our programs as possible.

Chairman ALTMIRE. I appreciate that. With that said, it is my understanding that a vast majority of the lenders that were brought into the program in the past year made only 1 loan, and were attracted by the Recovery Act, which, of course, is set to expire after this year. So I was curious what you are going to do to retain these lenders and increase their participation after this year.

Mr. ZARNIKOW. It is not necessarily atypical that a community bank, a smaller lender out in the country, would only make 1 or 2 SBA loans a year. In some cases, they may only make an SBA loan every few years. For a smaller lender in their community, they really are lending programs focused on expanding access to capital, so if the lender can make the loan conventionally without needing the SBA guarantee, then that is what they do. They make the conventional loan without the SBA guarantee, so they really utilize our program to expand access to capital in situations where they need to reach a little bit further down the credit box. The loan doesn't meet their conventional lending standards, so seeing that we have a lot of lenders who only make 1 or 2 loans a year is not at all atypical.

We are very focused from an SBA perspective on customer service and being customer service friendly. That may sound odd coming from a government agency, but we really think of small businesses as being our customers. Our lending partners are the people that we utilize in reaching our customers. In essence, they are our distribution channel. So we have embarked on a lot of things to really be better partners with our lenders. An example of that is in our guaranteed purchase program. Part of centralization at times was a difficult process and getting it right and getting the right level of staffing in the centers, getting the processes correct, has taken some time. We have been very focused on a continuous improvement process.

One of the things we have done is embark on what we call a ″brand promise″ that deals with our 7(a) guaranteed purchase process. We have made a ″brand promise″ that if a lender submits a complete purchase package that we will make a decision on that package and get them paid within 45 days. We are currently seeing that about 60 percent of the loans that come into our Herndon center on a 7(a) guaranteed purchase are meeting the brand promise where the lender provides a complete package when they submit it. Our decision these packages within the 45-day period, 1 example of how we are trying to be a better partner with our lending partners.

Chairman ALTMIRE. Thank you. And a lot of the discussion that comes up, as you can imagine, is the balance that the SBA takes between the size of the loan versus the number of people who can access SBA lending opportunities. And we looked at a statistical projection of the agency's loan distribution which indicates that even in the best of circumstances less than 50 loans would be made in the $5 million range through the SBA, and this follows the logic that business is emerging from an economic downturn. We want to be cautious, of course, and take on smaller amount of debt, no more. So why then is the SBA so focused on a proposal to increase loan size when it appears to the outside observer that it should be more concerned about smaller loan amounts?

Mr. ZARNIKOW. At the agency we are concerned about loans of all dollar amounts, and what we have seen after spending a lot of time trying to understand what market gaps are is that there is a way for the SBA to appropriately balance that expanding access to capital while also appropriately managing risk. One of the gaps we have seen is that with the changes in the credit markets, changes in the economy, that somewhat large or small businesses have had a harder time accessing capital much like very small businesses have had at different times. And, therefore, increasing the loan limit would allow those somewhat smaller, but still small, businesses have greater access to capital.

We find, too, that large or small businesses disproportionately are bigger job producers so we think it is important from a job production standpoint. And there are certain industries when you look at manufacturing industries, franchise industries, exporters, where we think the larger loan size is particularly important, but we don't think that that comes at expense of the smaller loans. What we find is the larger loans in our portfolio typically perform better and actually help subsidize the cost of the smaller loans.

Chairman ALTMIRE. Thank you. The last question for Mr. Zarnikow for now, later we will get to the others, but I want to focus specifically on the district that I represent, which you are right smack in the middle of right now. It is a 6-county district that has a mixture of high tech, high growth areas and heavy manufacturing, industrial areas that, of course, over the years have seen the loss of some of those manufacturing jobs, so it is a very good mix. I think it is instructive for the SBA to look at the recovery and how it affects a district like this. And SBA data shows that the number of loans made in the 4th district will likely remain constant this year and the dollar volume has already surpassed all of last year's $2 million with a year to date total for 2010 expected to be $21 million.

And this would suggest that lenders are making bigger loans instead of extending credit to a greater number of small businesses who in turn drive job growth, what we were just discussing. I was wondering if you see this to be the case in western Pennsylvania, and if you have it in this district in particular.

Mr. ZARNIKOW. The numbers you quoted would be consistent with what we have seen, and I think it is pretty consistent with what we have seen nationwide which is our average loan size has been increasing. Some of that is the smaller dollar loans or smaller businesses typically don't have as much collateral or don't have as much of a track record, and that makes it harder for lenders in the current environment to extend loans to them. So in the end businesses still need to be creditworthy. Our programs are loans. We, with partial government guarantee, help lender expand the credit box but in the end the small businesses still need to be creditworthy.

I think that the current economic environment and the credit environment has probably been typically harder on a start-up type business where there isn't a track record that a bank can look at where the business doesn't—or where the business or person doesn't have much in the way in collateral. But I would say that even given in the current environment we are still seeing that about 25 percent of SBA loans are going to start up businesses, so compared to the conventional market we still disproportionately support start-up businesses.

Chairman ALTMIRE. Thank you. I am going to move to Marilyn Landis. Ms. Landis, I want to give you the opportunity to publicly voice concern about something that we have talked about many times, and that is the extent of the credit crunch facing small businesses demonstrates the problem with relying entirely upon the private sector for a solution, and I was wondering if you could talk about whether you think that banks alone will be able to meet the credit needs of small businesses or if it is time that we look for other solutions, and, if so, what you would propose.

Ms. LANDIS. I think the banking industry has built a long tradition of managing credit risk very carefully looking at all the things that determine whether or not somebody is creditworthy. I spent a lot of years in that industry and I understand the scoring mechanism. Do we have appropriate collateral? Do we have sufficient liquidity? Do we have an increasing sales line? Do we have an increasing net profit line? What does the owner's personal credit score look like? What is the debt ratio? All of those have built a body of evidence that the regulators use when they come in to look at the bank to determine if this loan is creditworthy or not.

In today's economy most of those things have been altered or completely blown away. Companies that are very strong from the credit model perspective may have reduced sales because they were smart enough to move away from a sale that is not productive and move into one that is. They may have taken slightly less profit margins because they were forced to but in turn made internal cuts in their system so they could survive. Business owners have loans through their own cash reserves so if you are looking at liquidity of a business it is not there. As a result, the model of a successful business has changed. Thirty-eight years ago when I started in banking, we knew how to do a projection loan and had a regulatory environment that permitted us to do projection loans without the collateral, without the historic cash flow, and what the misnomer is that all projection loans are startups. That is untrue.

In today's economy the vast majority of businesses were here with their sales. They dropped to here with the economy and that curve is growth. They have got to go back on a projection loan to where they were before, which is where their sales would slightly extend beyond their ability to pay. The lending community is made up of a lot of very bright people and in time they will come up with new models. They will build the body of evidence that the regulators will accept so that they can follow that model and get the credit ratings that they need to get there, but that will take time. In the interim, there are private lenders who do not have to meet the same regulatory requirements who have personal capital at risk of their investors, their stockholders, their depositors that are willing to test some of these new models and that is happening, and it is exciting.

I also think there is a role for the SBA to enable the banks to take some of those risks and set these new paradigms to make that possible because the reality is indeed the business that can afford a large commercial real estate loan probably is in a building that is too big for itself, and what the most valuable asset a business has today is its people, its patents, its process, its intellectual properties, none of which we have mastered a model to be able to lend against that will stand up against the rigors of the regulatory environment, so I think it is important to explore 2 things, one, lending opportunities outside the traditional banking structure to give the banking structure time to rebuild and to heal. Second, to enable individuals to expand their business so that they can go back to a traditional bank for the more traditional loans like real estate or heavy equipment.

Chairman ALTMIRE. Thank you. Mr. Leyh, if we want to create new jobs, which, of course, is the priority, it is critically important to encourage creditworthy businesses, many of whom have remained on the sidelines, to enter the credit market, and to do so some have proposed giving small business loan deferrals for up to 6 months or 0 percent interest for the first few years. In your opinion, would these types of incentives get small business customers to apply for loans, and, if not, what type of loan incentives would be needed?

Mr. LEYH. When you reduce the cost of funds in any way, whether it is no interest, deferral of payment, you put an economic benefit in the hands of the requester, the borrower, and obviously it will make a very positive difference. The things you have to weigh are is it a short-term fix or is it a long-term fix and certainly a program like that would not be a long-term fix because it is not a long-term sustainable type of stimulus.

But in the short term there certainly can be a value especially in regards to an existing operation that is attempting to come back from a tough economic time and giving it a lower cost of funds is going to be a plus.

Chairman ALTMIRE. And, certainly, Mr. Leyh, you and I have discussed this next point many times, but I was wondering for the record if you could talk about the fact that some financial regulators and some of the banking industry have told me that the primary reason for the decline in small business lending is that firms aren't applying for the loans in the first place. Has a decline in this loan demand been something that you have seen in your business, and, if so, why do you think it is occurring?

Mr. LEYH. In the discussions that I have had with other bank presidents being in my role in the executive committee for the Pennsylvania Association of Community Bankers many of the small banks either have a bad experience with SBA or listen to stories second hand and it scares them away from the program. There in the past was a strong push, and I know Karl does in this local district, have an attempt to get out and visit with the banks and try to overcome those issues. But when you hear stories, and I think if you look in my example we all know the liquor license, liquor story from Dollar Bank, and that scares away a lot of people. And so there has to be a better job. The SBA has to do a better job. And it is a much more challenging environment now with centralization.

That is kind of why we push hard for that go to person in the local office because a local presence like Karl going out and talking to people and trying to get them in a program doesn't really have the ability to succeed without the authority behind him to cut through the red tape and to get some things done. When somebody is new in the program, we are used to the program so things become second nature, and we still have challenges, but it is very hard to empathize with a startup bank getting into the program and running into a roadblock and having centralization. And if you put those factors together, it is very frustrating to be involved in a program. There needs to be a local presence. There needs to be an authority behind that local presence to break down the barriers.

Any large organization, and SBA is a large organization, no matter how efficient it becomes, has to have a local touch with authority or it is going to become like the Wal-Marts or the K-Marts or Exxons where they lose some of their efficiencies just based upon their size.

Chairman ALTMIRE. I want to give Mr. Kaluhiokalani a chance to talk about that issue, and then I will give Ms. Landis and then finally Mr. Zarnikow on this question a chance to weigh in.

Mr. KALUHIOKALANI. Thank you, Mr. Chairman. I agree with Ms. Landis about the issues that are facing small businesses, and I can relate with my own experience. When I started my company, we were doing very well. I went to a bank, borrowed, actually established a line of credit as a cushion in the event that something would happen I would always have something available that I could fall back on to draw and to help with operating capital. In my business, the real estate market, I am very sensitive to the real estate market and when the economy started failing in that area, my business suffered dramatically. So, again, I started to rely on my line of credit to draw down and try to help me through some rough spots and try to continue to grow my business or replace the business that I was losing in the commercial markets.

One of the things I did was turn to the government procurement trying to go through the certification process with the SBA. But my point is during that period my line of credit was cut off. I lost my line of credit. So I had to find alternative means of financing to try to keep my business going and I had to turn to the private sector and get an investor involved in my company and now shares ownership with my company to keep me going. And I am not the only one that has a small business that is in this position. And what has happened, once you lose your ability or your revenue source or reduction the bank automatically did a credit check and they said because of the change in your credit score that is why we have cut off your line of credit. Well, you know, now what do I do, and now the situation snowballs and there is no way that my business, and I am just being very honest, could go to a bank today and get a loan. It is just not going to happen because of the policies that the lender has.

And again I am not the only small business in that situation, and as I pointed out, a great percentage of businesses, small businesses, have less than 100 employees, and they are the ones that are really suffering with the lending policies that are out there now. Those with 400 or 500, you know, they have revenues, $50, $60, $70, $80 million a year. You know, they have a good balance sheet. Those small businesses under 100 employees don't.

Chairman ALTMIRE. Ms. Landis.

Ms. LANDIS. You have heard me say this before. Small businesses are small not because we are too stupid to be big, so if we don't think we have a realistic opportunity to either secure the loan or pay it back, we are not going to ask to borrow. I think the biggest thing that has prevented small businesses, as you mentioned, your line of credit being cut back. The biggest impact of a small business being both creditworthy under the traditional sense and the ability to reach out and borrow has been the variances of the credit card industry. It has become the wild west of finance. In many cases, small business owners have been impacted by the very fact that they were growing fast or as I relayed to you earlier paying down my debt. I paid down a major credit card I used to open my New England office, and I paid it down by two-thirds.

The credit card company rewarded me by cutting my credit limit to the outstanding balance, so now instead of being 33 percent utilized, I am 100 percent utilized. That dropped my credit score which prompted 2 other credit cards to drop my credit limit which further dropped my score. Am I going to go to the bank and borrow when my credit score dropped? Even if it is still within acceptable standards psychologically I have been impacted that my credit score is bad. You add to that that another credit card company, and, again, I have made all my payments on time, tripled the amount of my payment each month. My health insurance has gone up significantly. As a result, I don't have the money to pay back a traditional loan. I need longer terms. I need some flexibility here if I am going to do that.

The other thing that impairs the small business owner are the gatekeepers. Many of the small banks, the individual is able to walk in and talk to a banker and get a feel for whether or not they can borrow. I have met with credit managers of very large banks who have no idea how many people are being turned away at the desk in their branches because of simple questions the borrower will ask. The people leave and somebody in credit says we don't have the applications. We can't lend the money because the people were turned away by the gatekeepers in the beginning who did not want to take the time to work with the credit. The industry has changed significantly for small business lending in that lenders by and large are rewarded on the volume they do, so if there is an easier loan to do you can't blame them for taking it and skipping the harder ones.

Those folks never make it into the credit pipeline to get counted so the credit cards, the industry, the nature of small business, the gatekeeper says do you have collateral, and they say, well, no, I have got my people, I have got my accounts receivable. Well, I am sorry, we can't help you, and they are not counted in your statistics.

Chairman ALTMIRE. Thank you. On that point, Mr. Zarnikow, do you have anything to add?

Mr. ZARNIKOW. I do think that information and data that we have seen at SBA is there has definitely been a pull back in the credit card industry, and obviously small businesses use a lot of different sources for financing. They use family and friends. They historically borrowed against their home either on a home equity line or using their home as collateral. They have used credit cards. They use traditional bank debt. So there are a lot of different sources of financing for small businesses, and a number of those have been impacted by the current credit environment. We do think that this is where SBA programs really play a critical role by providing the partial government guarantee. It does encourage banks or other lending partners to stretch the credit box.

We believe the Recovery Act has really worked, that the fee relief from the higher guarantee has really driven a big increase in SBA lending volume up over 90 percent, and that long-term extension of the Recovery Act is really a critical thing to keep access to capital for small businesses going.

Chairman ALTMIRE. Thank you. And with regard to default that takes place although rising defaults in the agency portfolio we believe were triggered by the recession these losses would not have occurred without overly permissive lending practices by lenders and a lack of oversight and risk management by the agency. I would ask if you agree with that or what your comment is about that and what you would do to try to correct those problems and extend any losses going forward?

Mr. ZARNIKOW. Sure. At SBA, we work through lending partners so we provide the guarantee. We do delegate a lot of authority to the lending partners to make the credit decision and have a system of oversight where we monitor lenders both through on-site reviews and also an off-site monitoring tool that was actually referenced earlier in the testimony. What we have seen in the portfolio is there has been a rising level of defaults. The curve that we have seen in defaults is very consistent with what has been going on in the broader credit markets obviously because with the partial government guarantee the lending partner is taking additional risk versus conventional loans. The losses that we are seeing in the portfolio are higher than what a bank would see in its conventional portfolio which is exactly what you would expect.

We have seen that, the change in the default curve has been very similar to what lenders are seeing, so we think that it is really a function primarily of what has been going on more broadly in the economy. Obviously, the increase in unemployment over 10 percent has had a pretty significant impact on the economy, and a significant impact on small businesses' ability to sustain sales and profitability, so what we have seen overall in the portfolio is pretty much what you would expect given the overall economic environment. I think we have seen a swinging pendulum in credit standards, which is not uncommon at all when you look at credit cycles where you see a loosening of credit and then there is a pendulum swing where you see a tightening of credit.

One of the things we monitor is the Federal Reserve's senior loan officer opinion survey where they actually survey loan officers on what is going on in their lending institution relative to credit standards, and what we have seen is that for the last number of quarters, I think it is 12 or 13 quarters in a row now, we have seen a tightening of credit standards. The most recent survey that came out showed that the credit standards were unchanged, which means we may be at the bottom of the tightening cycle. We have definitely gone through a very significant tightening of credit based upon the surveys that we see.

Chairman ALTMIRE. Would you expect that trend to continue? You say you think we are at the bottom now. Do you expect an uptick?

Mr. ZARNIKOW. What I would expect, I think what I was referencing was the tightening of the cycle, so the most recent one basically lenders weren't continuing to tighten but they also hadn't begun to loosen the credit cycle yet. My own expectation is that the worst is behind us as far as tightening of credit. It may be a while yet before we see a loosening of credit as banks rebuild their balance sheet and the small businesses have an opportunity to recover from the current economic climate.

Chairman ALTMIRE. Thanks. I thought of something as Ms. Landis was talking a moment ago, many businesses that I have spoken with have expressed frustration that despite interest rates being near all time lows, near zero, heightened scrutiny from regulators has made banks unwilling to make more loans, so in the context of what we were just discussing a moment ago, I was wondering how you felt we could address that problem.

Ms. LANDIS. The problem is not the interest rate. The frustration is that the interest rates are low but we can't get at them. Many businesses are borrowing at 18 or 20 percent if they are using a factor of purchase order financing or contract financing from private lender and they are making a profit with those dollars. It is a matter of having access to the dollars. That was one of the reasons we talked about the rate cap increase. We can absorb some interest rate impact. The frustration is the difference when the headlines tell us that there are such low rates available. Obviously, if we could repay a loan at a lower rate, it would be much easier for us to pay it back.

But if you based your business model on your cost of funding credit cards, for example, small businesses don't use them because we aren't smart. We use them because that is what we were given. Twice I applied for a line of credit. Both times I was approved. Then they sent me the credit card. I had not been improved for a line of credit. I had been approved for a credit card. That is true of small businesses across the board. As a result, they are now paying 27, 29, and 30 percent interest rates and they are paying significant larger payments. Is it hurting them? Absolutely. And is it increasing defaults? Perhaps, because of that. But if your model is built around that higher rate, you can absorb some rate increase but the frustration is huge and it is not so much that I am paying 27 percent and somebody else is paying 5 is that the only money I could get was at 30.

And you have a feeling that the 5 percent was a giveaway. There is an over emphasis on purchase of a home. I am sorry. For a small business owner who would like to pay their employee enough to buy a home, that is more important, is payroll.

Chairman ALTMIRE. I wonder if you and Mr. Kaluhiokalani could address as a business consultant if you could describe the role the technical assistance mentoring and other services can play in helping new entrepreneurs successfully borrow and build a sustainable business.

Ms. LANDIS. We have had 20 plus years with a small business owner who wanted to borrow money could walk into a bank, flash their credit score, talk about the equity in the home and nobody read their business plan. As a result, we have fostered a generation or more of small business owners who never had to do the tough job of really building a good balance sheet and a good income statement and really knowing if they could afford that loan, that payback, that interest rate. I worked for a lender that is not at this table that will remain nameless, a national one, that the deal was there are certain professions, if they were breathing they could get a loan if they had the credit score and they had the equity in their home.

These business owners are now for the first time facing the reality of having to produce a balance sheet and an income statement. That is the world I work with every day. These are bright business people, and when I show them how to use an income statement and a balance sheet, they get it. There are wonderful things that are happening to the way they can manage and run their business, but we raised a couple of generations of folks that never had to pass that test before and they need technical assistance to get there, absolutely.

Mr. KALUHIOKALANI. I would agree that small businesses would find value in education, on the technical aspects of financial planning. Just going in up front knowing exactly what the risks are, how to mitigate that risks, what sources of financing are available, what happens if there is a shortfall there, and have a plan to recover. I mean obviously our situation with the economy if there is a dip in the economy how are you going to survive that. So a program established up front for the financial health of the company that is growing or someone planning on going in businesses, I think is a very valuable tool for them to succeed in the long term. Unfortunately, there aren't enough programs available out there. Even your small business development centers are stretched to the limit and they only have a certain amount of capacity to assist a small business, but I think more emphasis needs to be placed in the up front planning of your business.

Chairman ALTMIRE. Thank you. Since you have the mile there, Mr. Kaluhiokalani, let me address this to you. Some have proposed to give small business owners a rainy day account. Under this proposal small businesses would have a special escrow account funded by the SBA set up at their lender's bank to use if the businesses should need temporary payment relief. Knowing they had a cushion during the recovery, do you think this type of assistance would incentivize more small businesses to seek a loan?

Mr. KALUHIOKALANI. It is a difficult question because, one, you have to know the terms, obviously. What am I going to have to repay and when do I have to start that repayment plan? What do I have to pledge up front in order to secure the loan? You know, what happens if the economy doesn't recover as fast as we would like? I mean there is a lot of consideration in even taking on something like that. If there were favorable terms, if it was a long-term situation, you know, until there is a time when the economy reaches a certain point or your revenue increases, I would feel comfortable but I don't think that is going to be the situation. A lender is not going to—even the SBA I don't think is going to wait forever for that money to be repaid, so I just don't see where it is going to have people running to the door to apply.

Chairman ALTMIRE. Ms. Landis, did you want to comment?

Ms. LANDIS. I did. What you just described was in the traditional banking sense a true work out. When a business ran into a hiccup, it could go in to its bank with a plan for recovery from that hiccup, whatever had caused it, fire, economic disaster, and truly have a workout plan whether it was a period of interest only, whether it was some additional funds because they saw the need to work through that. We have also had several decades where the bank didn't work out, the bigger banks simply did not do a work out. They liquidated. As a result, there is not the skill set, particularly in the larger banks, to really understand. That is a good old-fashioned—I spent 4 years collecting delinquent loans, and I would sit down with the borrower and say, well, what can you afford and what can you do and what are you doing about it?

And we built that reserve fund and, in some cases, lent money to a distressed company under special terms because we could see they were coming out the other side. That is good old-fashioned workout. That is what needs to come back. The banks need the flexibility to do that.

Chairman ALTMIRE. Thank you. Mr. Leyh.

Mr. LEYH. I can't speak what happens at other banks. I can speak what happens to ours though. That principle is done now on a routine basis. SBA statistics are 2 out of 5 businesses, I think, fail in the first 5 years. We do almost all small business lending. We are probably in work out discussions and work with people constantly. About 20 percent of our actual lending base is in some form of work out, distress, or needs help. I can't speak for everybody, and I certainly can't speak for the larger banks but in our case that is what we do. We also have a small business research center that people can come in and help create a business plan.

Selected professionals look at the pros and cons with different professionals, get help whether it is advertising, accounting, business plan, referrals to CDCs who have time available to work, and consultants. There are people out there that do that type of thing. When we make recommendations or think about empowering a private lender system versus the banking environment remember what we have. I mean we have a financial crisis because we have people outside the banking system who weren't regulated who created the problem. That is what happens when you go to a line of business that is nor regulated. People will take advantage. I mean that is part of the capital society.

And if you a weakened player, then you are going to be taken advantage of. The banking system on the other hand has regulations that prohibit that from taking place. The issue you have is unlike other industries a regulator can actually take your bank from you. I mean they have that kind of authority, which is not in other industries. So they have an incredibly strong influence. And so if you are going to want banks to do things, you are going to have to go to the regulators that are in the safety and soundness arena and say we want you to do these things. The same issue that we have in banking is the same issue that I talked about that we have with the SBA with the new lender rating system.

On one hand, you want safety and soundness. On the other hand, you want aggressive lending when there is higher risk. You have to give a clear cut set of rules to all the players that says here is what you want. If you don't send a clear message then people will get conservative or do what they need to do to protect themselves. So if you want more aggressive lending, you have got to go to the regulators and say give the banks a chance. In our case, the things that you are complaining about, I think are realistic in most banks. They aren't in ours. The regulators have been very, very good with us allowing us to do work outs and work with people and probably give us the benefit of the doubt because we have had 10 years of doing what we said we could do, and when that occurs then they give you the benefit of the doubt.

Other institutions have to do the same thing, so I don't think going to private lending is going to be the end all of all because you will have then problems without there being regulation. You have an industry, it is a well capitalized industry in the banking environment, but you are not going to get them to do these things in the norm unless you get the regulators to work with them. You can't have Congress saying lend and a bunch of regulators on the other side saying if you make that loan, you won't have a bank anymore in really that simplistic terms.

And you have to create the balance in between just as you do with SBA. You can't go to me and say I want you to do ARC loans. I want you to go do more aggressive loans. And, by the way, if you have losses or when I credit score your businesses they are not high enough, well, then your lender ratings are going to go so low that we may tie your hands up and ask you to leave the program or reduce what lending we are going to allow you to do. You have to give us a clear cut set of rules to live by. Then everybody knows what the game plan is.

Chairman ALTMIRE. Thank you. We have gone over it a little bit but I still wanted to finish up 1 more question with Mr. Zarnikow specific to the district again where you are right now. Pennsylvania's 4th congressional district is on track to double the number of 504 CDC loans and quadruple the dollar volume of those loans this year compared to FY 2009, and that is one area, of course, where

SBA lending has seen significant growth in the 4th district. However, there is some evidence, some experts believe, that the commercial real state market may be in for a collapse similar to that experienced in 2006 in the residential market, which it goes without saying, would bring significant losses to both the SBA and the taxpayers. So does the SBA have policies in place to mitigate some of these risks associated with commercial real estate in the 504 CDC program if that were to occur?

Mr. ZARNIKOW. Basically the 504 program is a program that is designed to help a business finance fixed assets. That could be machinery and equipment. It could be land and a building. It could be a combination. It provides a long-term fixed rate financing for that small business that is tied specifically to job creation and job retention. The structure of the program requires about a 50 percent loan to value first mortgage being done by a conventional lender. SBA does up to 40 percent with its second mortgage position debenture, and then the small business puts in at least 10 percent equity. In all cases in SBA lending, the primary source of repayment is the business being successful, the cash flow of the business, repaying the loan, and that is really the primary thing that we look at.

Obviously, to pin down what happens in real estate cycles, real estate cycles go up and down, values go up and down. If the business is successful then the business repays the loan out of the cash flows of the business it generates. We are concerned at SBA about that there could be a coming commercial real estate refinancing issue in the conventional market. If you go back and look at the conventional small business or commercial real estate market a lot of the commercial real estate mortgages are done with a long amortization but a shorter term maturity where the loan may balloon in 5 years or 7 years or 3 years--unlike SBA that has long terms

What we are concerned about is in marketplaces where there has been a significant decline in value that those loans may no longer qualify for conventional lending standards, and as a result the lender may not be able to or may be unwilling to roll over that loan. We have proposed as an administration to utilize on a temporary basis the existing SBA 504 program to allow refinancing of those loans. This would not be a situation where we are taking on risk of businesses that aren't performing or that are bailing out the banks. It is really to try and address situations where the loan is performing. The small business is making its payments, but the loan no longer qualifies for conventional mortgage standards that would allow it to be rolled over in the conventional market.

So we propose to basically do a 504 to allow refinancing of owner-occupied small business commercial real estate into the 504 program on a temporary basis to try and address that situation.

Chairman ALTMIRE. Thank you. I will close by asking each of you, starting with Mr. Zarnikow, and then we will move from your right to left, is there anything that you wanted to make sure was in the record that you weren't asked that you wish you were or any statement that you wanted to make that we overlooked in talking about this afternoon?

Mr. ZARNIKOW. I would just like to thank you again for holding this hearing. I think it is very important to hear what is going on out in the marketplace. We spend a lot of time talking with small businesses, talking with lending partners to try to and craft smart solutions to the existing problems. We do think that the proposals that the Administration have made, and particularly extending the Recovery Act, the 90 percent guarantee and the fee relief are critically important, increasing the loan sizes, and also allowing for the 504 refinancing provisions, as well as the small business lending fund that is really a treasury program that would help provide capital to small banks to help them increase their small business lending.

Chairman ALTMIRE. Thank you.

Mr. ZARNIKOW. Thank you.

Chairman ALTMIRE. Mr. Leyh, is there anything that we missed that you wanted to add?

Mr. LEYH. No. I appreciate the opportunity and I think it has been all encompassing.

Chairman ALTMIRE. Thank you. Ms. Landis.

Ms. LANDIS. I just want to thank you that I gave the opportunity to address the fact that, as I said earlier, most of us don't need another building right now. And I am seeing across the U.S., and I have clients—I have offices from California to New England, I am seeing small businesses taking a second breath. The first breath was I am here. The second one is I think I can go forward. And there are 78 percent that have growth plans for the coming years and of those about 57 percent have growth plans for this year. These are people who have survived and are moving forward. They need working capital, desperately need working capital.

Mr. KALUHIOKALANI. I just want to thank you again for allowing me to testify today, but also I wanted to say that there needs to be a real emphasis on the SBA and its programs to continue to develop those programs and revise them as needed, not just only in the loan program but in other business development programs that the SBA is in charge of. The SBA traditionally has had a loss in budget, staffing, and they are so overworked right now to even have somebody communicate with you is a real challenge for a small business, so I believe that they really need some help internally and also from Congress in the form of funding, additional funding, for their programs. Thank you.

Chairman ALTMIRE. Thank you. Thank you all. And I would say for the record once again that I would hope that the other members of this Committee would realize that these really are as expert a witness panel as we could possibly have come up with in western Pennsylvania. I think this has been a great discussion, and it is going to be very helpful to the Committee in moving forward to try to address these issues. So I would, therefore, ask unanimous consent that the record be open for 5 legislative days. Having heard no objection, so noted. This hearing of the Committee on Small Business, Subcommittee on Investigations and Oversight is now adjourned. Thank you.

[Whereupon, at 3:18 p.m., the Subcommittee was adjourned.]

U.S SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

Testimony of Eric R. Zarnikow
Associate Administrator for Capital Access
U.S. Small Business Administration
U.S. House of Representatives Committee on Small Business
Subcommittee on Investigations and Oversight
"Access to Capital for Small Businesses"
May 17, 2010

Thank you, Chairman Altmire. I'm honored to be here today.

One of the missions of the Small Business Administration is to help facilitate small business owners' access to much needed capital. We do that primarily by providing a partial government guarantee on loans given by banks and other lending partners. This guarantee helps provide access to capital for creditworthy small businesses that would otherwise be unable to get loans.

To address disruptions in the credit markets, the Recovery Act temporarily raised the maximum available guarantee on some SBA loans to 90%, and allowed us to reduce or eliminate most of our fees.

The raised guarantee provided an extra incentive for risk-averse banks to lend to small businesses, and the fee reductions made the loans more appealing to borrowers. These actions combined with an improving lending market generally have helped SBA lending increase by about 90% since passage of the Recovery Act.

We've turned about 600 million dollars in taxpayer funding into support for about 26.5 billion dollars in loans to small business owners. This includes over 637 million dollars in Pennsylvania, and over 40 million dollars here in the 4th district.

We know that times are still tough for small business owners. While SBA's Recovery loans are helping, it's clear that many small business owners are still having a hard time getting access to credit. Moreover, declines in home values have hurt small business owners, because many entrepreneurs use home equity to finance their business. We know that there is still more work to do.

At the SBA, we have examined how to use our programs to address demand for credit, availability of capital, and risk tolerance, and with the President we have proposed a jobs plan which targets gaps that still exist.

There are 5 key components.

1. First, to address the issue of banks that still have trouble taking risk, we've asked for an extension of the increased 90% guarantee and reduced fees until the end of fiscal year 2010.

2. Second, for banks that don't have the capital to lend, we've asked that Congress direct 30 billion dollars to a Small Business Lending Fund, to provide capital to community banks to allow them to lend more. Community banks tend to lend a greater share of their assets to small businesses. This money would come with incentives to increase lending to small businesses.

3. Third, many small businesses need bigger SBA loans to create jobs – franchisees, manufacturers, exporters, others. We want to permanently increase our top loan limits from \$2 million to \$5 million (from \$4 million to \$5.5 million on our 504 loans to manufacturers).

4. Fourth, for businesses that can't find access to working capital, we need to temporarily raise SBA Express loan limit from \$350,000 to \$1 million through Fiscal Year 2011. These loans will help businesses restock shelves and fill orders coming in.

5. Fifth, we know that many small businesses have conventional, owner-occupied commercial real estate mortgages that will need to be refinanced soon. As real estate values have declined, many banks will find that these businesses no longer qualify for conventional loans, regardless of the strength of the businesses. As a result, even small businesses that are performing well and making their payments on time can have a hard time refinancing these loans and may face foreclosure.

   So, we want to temporarily open up SBA's 504 program through Fiscal Year 2011 with an option to extend through Fiscal Year 2012 to commercial real estate refinancing. It's critically important that we prevent creditworthy firms here in Pennsylvania and across the country from facing unnecessary foreclosure and lost jobs. 504 refinancing will allow them to lock-in stable, long-term financing, while freeing up banks to make even more small business loans.

This plan is guided by basic principles: build on what works, maximize limited taxpayer dollars, and make targeted changes as quickly as possible. It addresses specific gaps in demand, availability of credit, and risk tolerance. SBA is confident that this will allow us to continue to help small businesses in this tough economic climate.

SBA is committed to building on the success of the Recovery Act, by expanding points of access and bringing more small businesses into a long-term banking relationship with an SBA lender. In addition, we will continue to work hard on behalf of small businesses everywhere. Our field staff and resource partners are standing by to help small business owners and entrepreneurs as they start and grow their business.

Small business owners here in Pennsylvania have access to:

- Two District Offices, in Pittsburgh and Philadelphia
- 17 Small Business Development Centers throughout the state
- 4 Women's Business Centers and a Veteran's Business Center, and
- Several chapters of SCORE, our retired executives mentoring service

I want to thank you for your support for small businesses, and for working with the SBA to get them the support they need. And I'm happy to discuss any of these proposals and answer any questions.

ENTERPRISE BANK

On behalf of Enterprise Bank and the Pennsylvania Association of Community Bankers, I want to express my appreciation to the Chairwoman Nydia M. Velázquez and Subcommittee Chairman Jason Altmire for this opportunity to speak about potential methods which will improve capital accessibility to small businesses associated with Small Business Administration (SBA) lending. Enterprise Bank is a community bank with approximately 200 million dollars in assets. We are a small business niche bank that specializes in assisting small business start-ups and small businesses in distress. We have been the largest dollar volume SBA lender in Western PA for the last two and one half years. The Pennsylvania Association of Community Bankers (PACB) is the oldest state bank trade association in the nation dating back to 1876. The PACB represents 150 locally owned, independent banks in the Commonwealth with combined assets approaching 90 billion dollars. The membership is deeply rooted in their respective communities and collectively has over 23,000 years of service to the citizens of the Commonwealth. Our comments are organized into four conceptual areas of discussion:

1.) Centralization
2.) New Lender Rating System and related risk management
3.) New Regulations
4.) Guarantee Payment Problems

These four areas of concern have driven many banks out of the SBA programs or diminished their use of the programs over the last four years.

Centralization was an important step towards improving efficiency in processing loan requests and guarantee requests. However, the loss of a local presence has created a bureaucratic communication nightmare. It has become almost impossible to promptly correct processing or interpretative mistakes made by the remote processing centers. We have direct experience with valid SBA loans being turned down by the processing centers because of misinterpretations of the SBA's Standard Operating Procedures (SOP). By the time we get someone to correct the situation in Washington, it usually is too late for the potential borrowers because they have lost the opportunity the funds were needed for, i.e. leased space, capitalize on a new contract, etc. A "go-to" person in the District Office that has actual override authority could diminish this type of injustice and lost opportunity.

In addition, the SBA is losing millions of dollars in recoveries through the 504 program because of the lack of a local presence in making timely collection decisions. Recently, we watched the bankruptcy court approve a sale against our wishes that paid us in full, but left no money to reimburse the SBA (i.e. the taxpayers) for its secured second position in the collateral. The collateral was worth twice our debt and was clearly sufficient to repay the government in full, but because the SBA did not enter an appearance in court, the taxpayers lost over 1 million dollars on this one transaction alone. A local presence with the appropriate authority could have stopped this travesty from occurring.

A further example of how a local go-to person could remedy the troubles associated with centralization is this: one local lender was partially denied a guarantee request because the lender did not sell the liquor it received upon foreclosure of a restaurant-bar. The processing center personnel were not aware of Pennsylvania law that prohibits any sale of liquor in this situation. This created tremendous frustration for the lender. As a result of this type of action, this particular

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lender dramatically reduced their use of the program. A local presence with authority could correct this type of issue on a timely basis. These are but a few reasons why each district office should have a go-to person, who has authority to correct these problems on a timely basis.

Our second area of concern that has diminished the use of the SBA programs in recent years is the new SBA Lender Rating System and the associated risk management. SBA lenders have become all too familiar with the results of the Lender Rating System. An SBA lender is rated on a 1-5 scale with 5 being the lowest performance evaluation for a lender. It is a tool that the SBA uses to determine if a lender is performing well and is a component of the decision to allow a lender to have Preferred Lender Program (PLP) status. This new evaluation program is embarrassed under the directive of risk mitigation. Lenders who actively participate in the SBA loan guarantee programs strive to maintain a PLP status because PLP status allows them to reduce the amount of paperwork and time associated with participation in the programs. To keep out of the proverbial "dog house" a lender must adjust its risk management via loan underwriting procedures to avoid sectors that have traditionally been the venue for the SBA loan guaranty programs. This includes restaurant loans, loans in neighborhoods or towns that are depressed, start-ups with little assets to collect against if the loan goes into default, and people with residences with little equity or no home at all, etc.

Risk mitigation is slowly becoming the means to erradicate the American Dream from the people that the SBA at one time held out as the means to become an independent business owner. Risk mitigation emphasis will cause the lender to lose sight of the SBA's mission by putting pressure on the lenders to reduce the "chance of failure" and thereby reduce the chance that the SBA may have to honor a loan guaranty. The lender rating is all important to a lender, life and death for a lender who relies heavily on the SBA programs to lend to small businesses. The natural reaction is to retrench and conform. To reduce the "chance of failure," lost is the "chance to succeed."

In addition to adjusting who the lender can lend to, a lender must also moderate loan size because if the loan goes into default and the lender submits a guaranty request, the size of the loan loss directly affects the lender's score. The SBA Lending Rating System results in the practice of making "small loans" in good locations to people with assets so that the lender never has to submit a guaranty request. The lender would naturally make such loans conventionally and would not need the SBA. But how many of those loans are there, and how does that idea help foster growth of American small businesses? Remember not all small businesses fail that receive a SBA loan guaranteed loan. Also remember that the bank has skin in the game to the extent of the unguaranteed portion of the loan. Our bank specifically chose not to participate in the SBA's American's Recovery Capitol (ARC) program because of the potential adverse affect on the bank's Lender Rating. By the nature of the loan, the borrowers were having problems and needed a loan to make loan payments. The chance of a failure would be high and the request to honor a loan guaranty would have an immediate and adverse impact on the bank's performance rating. This result most certainly does not comply with Congressional intent for the ARC program.

Our third area of concern as an SBA lender is regarding some newly implemented SBA regulations and policies as concerns the 7(a) and 504 programs. These new regulations are making it more difficult for lenders to comply with the SBA requirements and get SBA loans approved or

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closed, particularly as it concerns commercial real estate. As the Western Pennsylvania commercial real estate market has become depressed with the overall economic slowdown, it is important that the SBA provide flexibility in its lending parameters where it concerns acquisition, refinance and new construction of commercial real estate. This is primarily because acquisition, refinance and construction of commercial real estate can provide inherent economic growth and job creation.

First, the SBA real estate appraisal requirements have changed with respect to financing new construction and/or significant building renovations. The SBA now requires the appraiser, who values a new construction or renovation project on an "as constructed" basis, to revisit the project after completion of the work. The appraiser is also required to certify that the project has been constructed substantially in conformance with the plans and specs. The SBA logic is that there may be a potential adverse affect on the appraiser's value given at time of loan origination if the scope and/or quality of the build changes, which is sound and reasonable policy. However, the issue is that appraisers are not necessarily comfortable or qualified to make a certification on the plans and specs as they are not architects, engineers or contractors. The concept is fine to revisit the site post-construction and confirm the value, but the SBA has pushed the appraisers requirements outside the expertise and purpose of their profession.

Secondly, SBA's latest environmental requirements, as it concerns commercial real estate, has made redevelopment of prior industrial areas difficult and excluded portions of the small business market, like gas stations, from receiving SBA financing. In areas like Western Pennsylvania, which had a significant industrial use past for commercial real estate and areas targeted for Brownfield redevelopment, there is a disconnect between SBA environmental policy and economic development opportunities in these prior industrial areas. The environmental review by the SBA taking place in centralized processing areas further exacerbates that disconnect, as the SBA environmental review officials are not aware of environmental initiatives, remedies and indemnities available to lenders in Western PA to stimulate industrial reuse.

Finally as it concerns the topics of appraisals and environmentals, banks are already heavily scrutinized on these issues in their commercial real estate lending activities from their primary regulators. The new SBA policies in these areas are adding an undue compliance burden on most banks.

Our fourth and final concern that banks share which has reduced their participation in the SBA lending programs is regarding problems with the guarantee repayments. It should be said that the SBA has improved its Guaranty Purchase processing by utilizing a standard 10-tab system. It provides a uniform method for lenders to follow and an organization of the material which allows an expedited review by the SBA. However, there are issues that still need to be addressed with the processing of the packages. The SBA relies heavily on "contractors" to review the packages. Oftentimes, these contractors have limited knowledge of the SBA's SOP and more so of common and reasonable lending and/or liquidation practices. As a result, errors in interpretation persist. This causes delays in processing the guaranty and inexperienced lenders frequently suffer repairs or adjustments to the guaranty that should not occur. The experienced lender with more knowledge of the SOP's will contest the wrong, but it requires time and money to do so. Quite often the lender is educating the contractor.

Furthermore, we have experienced lost files. On a follow up to the SBA, we have been told

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they never received the package. However, we have tracking information via FedEx that shows they did. Regardless, another package has to be sent. We have experienced a contractor asking for information that was sent and not discovered within the package. Again duplicate material is sent and again delays occur. We have experienced delays when there are two loans to the same borrower that are submitted at the same time. On occasion, they are reviewed by two different contractors, who have come to different conclusions on the same facts. We have had delays when one package has an issue and the other loan processing stops; loans are supposed to stand on their own. In one case we waited over 10 months for the SBA to be convinced they were in error on a fee payment on one of two loans. It took months for the SBA to align its computer system to show the fee was not an issue. The Finance Center had to correct the records before the processing center could input the purchase for payment. There was no sense of urgency. It took numerous telephone calls and several letters and ultimately the attention of the Ombudsman to resolve the matter. Delays cost the lenders money and more importantly for the economy, delays cause lenders to avoid using the SBA programs which are an important component of stimulating growth for small businesses. The lenders need a "go to" person at the district office that can correct these issues on a timely basis.

Congressional action to raise the 7(a) program guarantee percentage from 75% to 90% created a huge incentive for banks to lend. Some are new, getting more active or reentering the program. However, these four conceptual areas of discussion have caused many previously active SBA lender banks to minimize or reduce their participation in the SBA programs. It is imperative that Congress reviews SBA actions relating to rule-making and risk management to ensure that the practice of such actions do not change the stated mission of the SBA or discourage participation in the programs.

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TESTIMONY FROM

Marilyn Landis, Owner
Basic Business Concepts, Inc.

HOUSE COMMITTEE ON SMALL BUSINESS
SUBCOMMITTEE ON INVESTIGATIONS AND OVERSIGHT

Hearing:

"Access to Capital for Small Businesses"

May 17, 2010

Pittsburgh, Pennsylvania

Good morning. My name is Marilyn Landis and I am the owner of Basic Business Concepts, Inc. a consulting and financial management company providing CFO level services to small businesses throughout the United States, with concentrations in Pennsylvania and Ohio. I am also the 2009 SBA National Financial Services Champion.

I would like to thank Chairman Altmire for holding this very timely hearing and for inviting me to be a part of it.

Prior to starting Basic Business Concepts, I spent 30 years working for and with commercial lenders, banks and small businesses throughout western Pennsylvania. I worked for three of the largest U.S. Small Business Administration (SBA) lenders in the country—marketing, originating and underwriting SBA loans—and have continued working with my clients on securing SBA loans as well as myriad other sources of capital. After 38 years of working with small business, the one thing I can tell you without hesitation is that it's tough out there. Small-business owners face many obstacles in trying to garner capital—obstacles that illustrate the very significant need for and importance of the SBA's lending programs.

Small-Business Challenges in Financing

Many small and startup businesses lack the assets necessary for a traditional bank loan. In 2010 these are the businesses who have burned through their savings, their reserves and even their retirement accounts to meet their obligations. They have scaled down to the new reality – found new customers – shuttered unprofitable lines – added new divisions with better sales prospects and margins. In sort – we did all the right, responsible things. We are here, receiving orders and unable to secure working capital. Smaller loans are generally less-profitable for banks, and typically have a higher default rate. The increased usage of personal credit ratings for business owners further exacerbates the problem. Additionally, ongoing bank consolidation has resulted in fewer community banks, fewer character-based loans, and more difficulty for the small-business owner.

One of the biggest barriers to small-business financing is debt secured by equity in fixed assets. Many small-business owners do not have the kind of equity required by banks to acquire a sizeable loan. This gap in debt-equity financing primarily hinders both startup businesses and growing businesses. An entrepreneur wishing to open any business would face significant barriers to financing, as home ownership (if the entrepreneur owns a home) rarely meets the equity requirements for receiving a larger commercial loan. The small-business owner seeking to expand his or her business or hire additional employees faces the same equity challenges. The balance sheets for most small businesses, especially in today's economy, are not composed of significant fixed assets – buildings and heavy equipment. Especially significant, in light of the emerging commercial real estate crises, even the fixed assets the business does own are likely devalued. The old adage, "You've got to have money to make money" has morphed into "You've got to have equity to get money"—which just does not make sense – especially today.

A new capital issue has come to the forefront for small businesses, and that is the increased reliance on credit cards. Many small-business owners were forced to turn to credit cards as their primary source of working capital in the early years of this decade when a multitude of banks tightened their lending standards. In fact, only 20 percent of the respondents to a 2006 National Small Business Association (NSBA) membership survey relied on traditional bank loans as their primary source of financing. Eleven percent exclusively used credit cards to finance their business operations. The high interest rates typical of most credit cards continue to adversely impact U.S. small businesses. In December of 2009 78% of the respondents to a NSBA survey reported that they had been impacted by the "credit crunch", causing 47% not to expand their business.

Bank regulators require business borrowers to have either equity in hard assets or historic cash flow to support their loan request. Rapidly growing businesses, like mine, that are not traditional brick and mortar, have neither. We are forced to use bank credit lines which, if not secured with equity in a home, are increasingly credit card accounts. As such these loans are subject to credit card regulations which permit significantly higher and more volatile rates and payment structures. Rapidly growing service and technology companies do not want to rely on credit card debt—they are forced to.

SBA Loan Programs

Banking practices that restricted access to capital were a key catalyst in the creation of the SBA's flagship 7(a) loan program. The goal, under the generally-accepted premise that small-business growth is a good thing, was to encourage greater lending to smaller, potentially riskier clients. As you can see, however, imperfections within the market still exist and SBA loan programs are as important now as ever.

While Congress should be pleased that the small-business provisions of the *American Recovery and Reinvestment Act*, specifically the temporary elimination of the upfront borrower fees and the increased guarantee, have had a positive effect on the lending programs at the U.S. Small Business Administration (SBA), they hardly were a panacea. In Fiscal Year 2009, the SBA approved 44,221 7(a) loans. This represents 36 percent fewer loans than in FY 2008 and 56 percent fewer loans than in FY 2007. The total dollar amount of these loans also plummeted—by about $3.4 billion—to $9.3 billion.

While not a cure-all for the credit crunch, the temporary elimination of the upfront borrower fees and the increased guarantee for SBA loans have been instrumental in a recent uptick in SBA lending. The SBA claims that the $500 million appropriated for these provisions since February 2009 has supported more than $20 billion in lending to small businesses across the country and has lead to an increase to its average weekly loan volume of almost 90 percent. The provisions also have helped entice nearly 1,100 institutions back to the SBA's lending programs. This is extremely noteworthy, as hundreds of banks had quit participating in those programs over the last decade.

Given this tremendous success, it is vital that Congress immediately extend these provisions through all of 2010 on a reliable, sustainable basis that the lenders can build strong origination and compliance programs around. The fact that SBA volume has mirrored the availability of this program confirms the lender's need for the increased liquidity it affords.

Increase Maximum Allowable SBA Loan Sizes

I also support increasing the maximum loan sizes for 7(a) and 504 loans, as called for *H.R. 4302*, the *Small Business Job Creation and Access to Capital Act*. While many entrepreneurs would be delighted with a $50,000 or $100,000 loan, a sizable number of larger small firms require loans in excess of the current limits. Unfortunately, it is difficult to obtain small-business loans in the $1.5-$5.5 million range—according such loans an SBA guarantee would greatly expand their availability.

Although the House already has approved legislation (*H.R. 3854*, the *Small Business Financing and Investment Act of 2009*) that would increase the maximum sizes for SBA's 7(a) and 504 loans, NSBA contends a larger increase should be enacted. NSBA also believes that these enhancements should contain a commensurate increase to the statutory maximum guaranteed portion of SBA 7(a) loans.

NSBA is not alone in this belief. Increasing the SBA's maximum loan sizes, with a commensurate increase to the maximum guaranteed portion, is supported by the administration of President Barack Obama, the chair and ranking member of the Senate Committee on Small Business and Entrepreneurship and a bipartisan collection of their colleagues, and dozens of organizations, representing millions of small-business owners in every industry sector. Inexplicably, however, *H.R. 3854* fails to provide this increase.

It is important to note that the Congressional Budget Office has scored *H.R. 4302*, the *Small Business Job Creation and Access to Capital Act*, at zero. In other words, this is a simple step that would help numerous small firms around the country and cost nothing.

Legislative Changes to the SBA Program

SBA programs have served a key role in making capital available to small businesses. The use of the SBA programs have enabled lenders to meet the needs of their borrowers with the SBA guarantee to mitigate the reach outside their normal criteria. The SBA has made changes to the Standard Operating Procedures (SOP) to meet both the need for increased credit quality and increased flexibility in order to meet current access to capital needs. There are necessary changes, however, that cannot be made solely through the SOP. These changes must be made legislatively. I would like to recommend the following procedural changes. First, permit borrowers to pledge additional collateral for a refinance, for example real estate, in order to secure a longer term/lower payment in order to improve cash flow. Currently the law does not permit calculating a SBA loan term based on the underlying collateral. Second, permit the SBA to work with lenders to support loans advanced against projected sales. This could be accomplished in more than one way. If the lender and the borrower agree to a projected sales plan that rebuilds the business, the lender would receive a reduced SBA guarantee for the first year, to assure both lender and borrower are committed to the viability of the projections. If the borrower makes all payments for the first year, the bank would receive an increase in the guarantee amount to the full amount available under the SBA program. A second way to support loans for projected sales is to raise the rate cap on the SBA CapLine program. These programs, which finance purchase orders and contracts, are by their nature more costly for the lender to offer. An increased rate cap would permit the lenders to participate in this program at a interest rate level that is commiserate with their requirements for profitability and still meet the borrowers need for affordable financing. A legislative change is also required in order to open the SBA's very practical international line of credit program to domestic receivables. Currently this program can only be used for international sales.

Small Business Research and Development

Increasing the amount of federal research and development invested in U.S. small businesses is an important access to capital goal. Small technology firms with less than 500 employees now employ 54.8 percent of all scientists and engineers in U.S. industrial research and development. Yet, these nearly 6,000 scientists and engineers are able to obtain only 4.3 percent of extramural government research and development dollars. This must change. NSBA urges Congress to build upon the successes of the Small Businesses Innovation Research (SBIR) program—which has delivered more than 50,000 technology patents and is now doing so at the rate of seven patents a day—during SBIR's reauthorization process and to increase the percentage of agencies' research and development funds reserved for small businesses

Small Business Lending Fund

NSBA is generally supportive of President Obama's proposal to create a Small Business Lending Fund, aimed at increasing community banks' small-business lending. NSBA has advocated using TARP funds to improve small-business owners' access to capital for more than a year.

Although programmatic specifics are not yet clear, the plan appears to address community banks' concerns with previous proposals and has earned the industry's strong support. Of course, NSBA would not oppose arming the proposal with lending requirements—or strong disincentives for community banks to receive the capital infusion but not increase their small-business lending—rather than only incentives, but further delay is not an option.

Small Business Credit Card Reform

I also urge Congress and this committee to address two additional aspects of the credit-card industry that urgently need reform: (1) the absence of explicit protections for small-business cards, and (2) the secretive and unfair interchange system.

<u>The Small Business Credit Card Act of 2009 (H.R. 3457)</u>

The largest loophole in the *Credit CARD Act* was the absence of explicit protection for small-business owners who use their card(s) for business purposes. Since the legislation amended the *Truth in Lending Act* (*TILA*)—which, except for a few provisions, does not apply to business cards—its protections were limited to consumer credit cards. Although the credit cards of many—if not most—small-business owners are based on the individual owner's personal credit history, it is conceivable that issuers could legally consider them exempt from the law's vital protections.

TILA defines a "consumer" as a "natural person who seeks or acquires goods, services, or money for personal, family, household use other than for the purchase of real property." While a small-business owner who opens a personal credit-card account and uses it occasionally for business should be covered under *TILA*, it is far from clear that this legislation would protect a small-business owner who used his card exclusively or even primarily for business purposes. Eighty-six percent of the respondents to NSBA's credit-card survey reported using their consumer or business credit-cards primarily or exclusively for business purposes.

Although in the past, issuers appear largely to have kept most of their cards in compliance with *TILA*, there is no guarantee this convention will continue, especially when one considers that its basis appears to have been practicality and not legal obligation. Since issuers were able to subject consumer cards to the most egregious of practices, there was little incentive to distinguish between consumer and small-business cards. An unintended consequence the *Credit CARD Act* is that it could provide just such an incentive.

Thankfully, legislation has been introduced that would correct this oversight and extend equal protection to the cards used by small-business owners with 50 or fewer employees. The *Small Business Credit Card Act of 2009 (H.R. 3457)*—introduced by Reps. Nita Lowey (D-N.Y.), Michael Michaud (D-Maine), Thomas Perriello (D-Va.), and Don Young (R-Alaska)—also contains an "opt-out" provision, so that small-business owners who did not want their cards protected in such a manner can choose to keep any current agreements.

H.R. 3457 is supported by a diverse range of small-business organizations and consumer groups—from U.S. PIRG to the Consumer Federation of America to the Associated General Contractors of America to the Hispanic, Black, and Women's Chambers of Commerce—and I respectfully request that this committee consider this bipartisan, common-sense legislation as soon as possible.

<u>The Credit Card Interchange Fees Act (H.R. 2382)</u>

Interchange is the fee paid by a merchant's bank every time a credit or debit card is used to pay for a good or service to the bank that issued the consumer's credit card. The fees—which vary depending on the type and size of the merchant's business, the way the transaction is processed, and the specific kind of card used—are set by Visa and MasterCard and the issuing banks and are not subject to negotiation. As much as $2 of every $100 in credit or debit card receipts goes to the card issuers, which inflates the cost of nearly everything consumers buy—since merchants are prohibited from surcharging the customers who use the most high-fee cards. It is important to note, especially as states across the U.S. raise their state sales taxes to meet budgetary shortfalls, that these interchange fees are based on the *total* transaction amount, including taxes.

Interchange fees originated in the 1960s as a way to cover the real cost of a credit-card transaction. Despite vast technological advancements, which have led to greatly diminished processing times and manpower requirements, interchange fees have more than tripled since 2001 alone. As Professor Adam Levitin, of Georgetown University Law Center, has noted, since "interchange is transaction-based revenue; the issuer doesn't incur the consumer's credit risk. That means that issuers can risk greater credit losses because they've already made a nice bit of money via interchange with virtually no risk. Not surprisingly, interchange has increased over the last decade from being about 13 percent of card issuer revenue to being 20 percent." In total, Americans paid more than $48 billion in interchange fees in 2008.

Visa and MasterCard force merchants to sign a contract when they decide to accept credit cards, agreeing to all current and future operating rules. Merchants rarely have seen these rules and are prohibited from disclosing their terms to consumers, preventing merchants from alerting their customers to the true cost of accepting credit and debit cards. Many argue that Visa and MasterCard, which control roughly 80 percent of the credit-card market, and their card network function like "price-fixing cartels," operating in collusion and in violation of federal antirust laws by using their market power to impose non-negotiable rates and terms on merchants.

The *Credit Card Interchange Fees Act (H.R. 2382)*—introduced by Reps. Peter Welch (D-Vt.) and Bill Shuster (R-Pa.)—directs the Federal Trade Commission (FTC) to fulfill a regulatory void and review the credit-card industry's interchange practices and rules. The bill also grants the FTC the authority to prohibit any practices that it deems unfair, deceptive, or anticompetitive; and prohibits a number of practices that clearly meet this definition.

In an attempt to provide transparency to the system, *H.R. 2382* also would require the Federal Reserve to collect and disseminate information on interchange fees and the rules that currently govern the system. It also requires the Visa, MasterCard, and the rest of the credit-card industry to make their operating rules available to participating merchants and the public.

Believing that *H.R. 2382* provides critical transparency to the currently shrouded interchange rules and addresses some of the most egregiously unfair, deceptive, or anticompetitive practices of the industry, the National Small Business Association, Americans for Financial Reform and more than 20 additional national trade associations have urged Congress to adopt it.

With America's entrepreneurs—existent and, importantly, aspiring—suffering through a crippling credit crunch, it is high time that Congress provide U.S. small businesses with the credit-card protection they so desperately deserve—protection against practices already identified as "unfair" and "deceptive" by the U.S Federal Reserve Board, the Office of Thrift Supervision at the U.S. Department of the Treasury, the National Credit Union Administration, and an overwhelming majority of the Congress.

If millions of new, small firms are going to be created during this recession—as they have been in previous recessions and economic downturns—then they largely are going to be financed through credit-cards, given the current lending environment. Although credit cards are an inherently expensive and volatile source of financing for entrepreneurs, they also are indispensable. Congress can and must ensure, however, that they are not allowed to function simply as a mechanism with which to siphon capital—through "unfair" and "deceptive" practices—from the backbone of the economy to the top 10 U.S. banks, which controlled 83 percent of the small business credit-card market (understood as their proportion of outstanding credit-card debt) in 2005.

The administration and Congress must fully support small businesses as the true centers of growth in the U.S. economy. Congress must recognize that the majority of small businesses in today's economy are not fixed asset-intensive and should take the lead in ensuring that traditional financing practices and new credit-card policies do not restrict small business growth. I urge Congress to examine the benefits of reforming the current limitations placed on banks in lending to small business and fully supporting and funding existing SBA loan programs.

I thank you for your time and welcome any questions you may have.

RRC Consulting Group
Physical Asset Risk Reduction & Control

700 River Avenue • Pittsburgh, PA 15212 • 412-364-3035
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Testimony before the Small Business Committee Subcommittee on Investigations and Oversight United States House of Representatives

On

"Access to Capital for Small Businesses"

May 17, 2010

Karl A. Kaluhiokalani, President
RRC Consulting Group, Inc.

Thank you Mr. Chairman for inviting me to present testimony regarding *"Access to Capital for Small Businesses"*. My name is Karl Kaluhiokalani, and I am the President of RRC Consulting Group, Inc., an SBA approved 8(a), Veteran and Native Hawaiian owned Environmental and Engineering firm participating in the Mentor/Protégé Program. As a member of the small business community and participant in SBA programs, much of what is discussed today has had a major impact on my business the same as others under similar circumstances.

Under the provisions of 13 CFR-101, **"The U.S. Small Business Administration (SBA) aids, counsels, assists, and protects the interests of small business concerns, and advocates on their behalf within the Government."**

In this period of economic stress, it becomes even more important to support small business through effective utilization and management of existing programs while correcting the chronic deficiencies identified and discussed by Congress many times the past several years.

The only mandated lifeline small business had over the years has been the SBA while agency effectiveness has been continually eroded. Past budget, staff and program cuts have hindered the ability of the SBA to properly manage programs, adjust to changes in technology and meet additional demands of a growing small business population. According to the U.S Census Bureau between 2002 and 2006 small businesses fewer than 100 employees have averaged an increase in employment of 24.8% while those businesses greater than 100 employees averaged only a 4.15% increase.

According to the SBA in a report prepared in September of 2009[1], small businesses;

- Represent 99.7 percent of all employer firms.
- Employ just over half of all private sector employees.
- Pay 44 percent of total U.S. private payroll.
- Have generated 64 percent of net new jobs over the past 15 years.
- Create more than half of the nonfarm private gross domestic product (GDP).
- Hire 40 percent of high tech workers (such as scientists, engineers, and computer programmers).

Given the recognized importance of Small Businesses to our economy, it becomes increasingly frustrating when emphasis has been placed on "Big Business". So far, billions of taxpayer dollars have gone to bail out financial institutions and the auto industry while little effective effort has been made to save the small businesses that are failing every day. Without jobs people can't buy cars, save money, or invest to make our economy stronger. Even though financial institutions received funds to ease the credit crunch, lending has only tightened forcing small businesses to close or go into bankruptcy. Credit lines have been canceled, loans are not available, and interest rates have risen on current lines of credit making it almost impossible for small businesses to survive and service debt. Anyone operating a small business has nowhere to turn while large businesses and financial institutions can plea to the government claiming the loss of jobs and investor funds would hurt the economy and create financial instability in the

[1] *http://www.sba.gov/advo/stats/sbfaq.pdf*

investment market. Given the statistics identified above concerning small business profiles, it would seem there is more impact on our economy when small businesses close in large numbers.

The recent changes in the SBA Loan Guarantee Program are more beneficial to companies with over 100 employees and of little value to the mom and pop type business, typically with less than 10 employees. A borrower must comply with the lending policies of the institution providing the loan, and without work or sales and a strong balance sheet, a small business is unable to obtain a loan. Rather than securing loans, most small businesses are in need of additional work or sales to pay employees, service debt and expand their business. Unfortunately the federal government does not have the capacity to assist all small businesses in increasing sales revenue, however through programs established by Congress, has the ability to influence federal purchasing and procurement. Most of these programs are administered or overseen by the SBA. However as indicated previously, the SBA has lost its' effectiveness and many of the established programs are in need of review and revision to make them work as intended.

An example of this is the HUBZone program. More than a year ago hearings were conducted concerning businesses not qualified for HUBZone certification being awarded contracts in the millions of dollars. A subsequent hearing was conducted resulting in a report some of the same companies again received contract awards. In response to this issue, the SBA reportedly improved the review process however in doing so made the process so cumbersome legitimate applicants suffer unacceptable wait times to have their applications processed. Additionally, inexperienced contractors are conducting reviews and reports from the small business community indicate there are a high number of denials being made. This is creating an undue burden on those qualified and eligible companies by preventing them from participating in HUBZone set-asides under ARRA and other procurements. Not only does this impact small business directly, but also impacts the community in which the businesses are located by delaying the opportunities for job creation in areas that were historically economically depressed, but in today's economy, suffer even more.

Many Small Business program areas have been ignored and small businesses are at a severe disadvantage against large business competition. It seems "big business" continues to be the favorite.

This situation has been discussed by Congress many times and examples of these deficiencies continue to be a problem such as –

- The small business size standard allowing a company having less than 500 employees to be considered small regardless of revenue is a hardship for many small businesses. This type of procurement continues to be utilized in the area of Environmental Remediation (562910) and has been a detriment. Many companies fitting this description have revenues in excess of $100M per year and intentionally keep employee counts below 500 to qualify as Small Business under this code. What makes even less sense is the size standard for construction (236220) is $33.5M, however construction is more labor intensive and the cost of materials makes up a majority of the contract. Given the activities both share, a revenue standard less than $50M should be established. Under this type of guideline, there are an abundance of small businesses capable of performing.

- The failure to accurately depict the number of small business contracts awarded against government minimum goals. This miscoding continues to be a problem even though committees in both the House and Senate have discussed GAO reports concerning this finding. More accountability on the part of each agency must be implemented and enforced.

- Counting ANC[2] award dollars toward small business goals. The ability for ANC's to participate as small businesses and acquire 100's of millions of dollars in set-aside contracts continues to skew small business contracting reports. When tallying contracted dollars to small businesses, billions in awards made to a small number of ANC's are counted toward agency small business goals. This method of procurement has become a fast way for contract officers and agencies to issue awards and satisfy requirements while restricting opportunities for other qualified small businesses. Issues concerning ANC's have recently surfaced in Congress and this particular situation should be a consideration.

- Awarding ARRA procurements to existing IDIQ contracts rather than seeking new contractors. This has not contributed to job growth, only shuffled employees from one area to another especially among large businesses. Each week there are hundreds of notices published informing the public an award will be made to an existing contract holder. A majority of these contracts were awarded prior to ARRA and leaves little room for small businesses new to Federal contracting the ability to participate.

- The continued bundling of contracts (now referred to as consolidation) rather than breaking them up to facilitate small business participation. This is limiting small businesses from competing even after teaming with a large business due to affiliation rules. In many situations small businesses are not able to meet the requirements of a sources sought and procurements become open competitive allowing large businesses to bid. PCR's and Small Business Utilization Representative in each agency need to be held accountable and scored for ensuring these opportunities are created.

- Requirements for small businesses to perform 50% of the work on contracts with their own employees on large consolidated contracts when large businesses can sub-contract almost all of the work on unrestricted procurements. Due to the size of many procurements, especially with the consolidation of services, more flexibility needs to be given to small businesses in teaming and or self-performance. The result without this flexibility will be an award made to a large business anyway. At least with more flexibility, the small business can act as the Prime and control the work.

- Failure of prime contractors to adequately utilize small businesses for sub-contracting when large businesses are allowed to set a minimum of **23% of <u>sub-contracted</u>** dollars to small business which could amount to a very small percentage of an overall contract especially if they propose sub-contracting a small percentage of overall dollars. Changes in procurement strategy are needed to ensure there is a minimum percentage amount of overall contract dollars sub-contracted to small business.

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[2] GAO-07-1251T

- Limited use of Sources Sought to determine availability of qualified small businesses. There are a number of small businesses qualified to perform work or provide products to under Federal contract. However the use of initiating a Sources Sought seems to be discouraged due to the extra time involved to procure goods and services. Agencies need to be held more accountable for utilizing the tools to find small businesses capable of fulfilling a procurement.

- Failure to make awards for small business set-aside procurements in a timely fashion. Small businesses spend a great deal of time, energy and money coordinating and preparing responses to requests for submittals only to have them held without decision sometimes greater than one year. Our firm currently has more than six submittals awaiting decision for over six months to include one approaching two years. Prior to issuing a solicitation, project approval and funding should be required to be in place and the procurement tracked by both the SBA PCR in the region and the agency Small Business Utilization Specialist.

On April 26, 2010, President Obama issued two executive orders to the Heads of Executive Departments and Agencies establishing task forces to "improve and increase federal contracting opportunities for small businesses"[3]. The actions cited in these memoranda are addressing issues identified several times over several years. What was missing from the documents was defining the role and responsibilities the SBA should assume to effectively meet this mandate. Also it was not clear if the data collection for use in the new small business website is from the same unreliable sources currently being scrutinized. Unless action is taken beyond what has been outlined in the memoranda, I fear the situation will remain the same.

In conclusion, each year both the House and Senate Small Business Committees discuss the issues outlined above. By the end of each session, the results are failed attempts to enact legislation to adequately address the issues facing small business. This has led to a chronic failure of agencies to meet their goals, the failure of the SBA to adequately administer programs due to budget constraints, no accountability and the continued excessive fraud and abuse in Business Development programs resulting in awards valued in the millions of dollars. I urge the members of Congress on behalf of myself and small businesses overall to address these issues with effective legislation to promote small business growth, create additional jobs and move our economy forward at a greater pace.

Thank you for your consideration.

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[3] http://www.whitehouse.gov/the-press-office/presidential-memorandum-interagency-task-force-federal-contracting-opportunities-sm ; http://www.whitehouse.gov/the-press-office/executive-order-interagency-task-force-veterans-small-business-development